



Memorandum

June 4, 2004

TO: Honorable Kevin Brady
Attention: David Malech

FROM: Steven Maguire
Analyst in Public Finance
Government and Finance Division

SUBJECT: Sales tax deduction in lieu of income tax deduction

This memorandum responds to your question about legislation that would allow federal taxpayers to choose between a deduction for state and local income taxes paid or state and local sales taxes paid. Specifically, you asked how much would taxpayers save in federal income taxes.

Taxpayers in states without a state income tax would receive the greatest reduction in federal income taxes from the proposal. Currently, there are nine states (Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming) without a broad based state income tax. Two of those nine, New Hampshire and Tennessee, tax only dividend and interest income. New Hampshire does not have a state sales tax. Thus, taxpayers in that state would not benefit from a choice between deducting income taxes or sales taxes. Many taxpayers in the remaining eight states would almost certainly pay less federal taxes under the proposal.

Only itemizers in these states would clearly gain from the allowance of a state and local sales tax deduction in lieu of a state and local income tax deduction. Taxpayers who use the standard deduction would not benefit unless they switched to itemized deductions. Taxpayers who already itemize deductions should gain the most from the proposal because the deduction for sales taxes paid would be added in full to their present deduction. If taxpayers are using the standard deduction, \$7,350 for individuals in 2000, then the net benefit of switching to itemized deductions (e.g., including sales taxes paid), would be the total itemized deductions less the standard deduction previously claimed. However, if a sales tax paid deduction were allowed, the number of itemizers in states without an income tax would likely increase, since many would then have itemized deductions greater than the standard deduction amounts.

The calculations in Table 1 focus only on the potential gain of current itemizers. An itemizer rate¹ is used to estimate the total sales taxes paid by itemizers (column (d) in Table 1) in a given state. The estimated sales taxes paid by itemizers is then multiplied by the assumed marginal tax rate of itemizers (30%). The potential tax savings for each state is provided in column (e).

The estimates reported in Table 1 likely understate rather than overstate the federal tax savings because the estimates assume that itemizers—typically high income taxpayers—pay an equal portion of sales taxes. Generally, high income taxpayers would pay a larger share of total state and local sales taxes. However, total taxes paid (column (b)) probably overstates sales taxes paid by consumers because collections from business purchases are included.

Please bear in mind that the estimates do not reflect any tax gain for those tax payers who switch from the standard deduction to itemized deductions. Their gain would be limited, as noted above, to the margin by which the addition of sales tax deduction put them over the standard deduction.

Tennessee is a special case. Tennessee currently taxes dividend and interest income. The taxes paid on this income would be included in the itemized deductions of those taxpayers who itemize. Thus, these taxpayers who choose to deduct sales tax in lieu of the income taxes would not gain as much as those in states without any income tax. The marginal gain should be reduced by the amount of tax savings that the income tax deduction generated before switching to the sales tax deduction. To account for this, total income taxes paid in Tennessee are subtracted from sales taxes paid. The result of this adjustment for Tennessee is reported in column (b) of Table 1.

There are likely some taxpayers in states with income taxes who would also experience a reduction in the federal tax burden if the proposal were to become law. Taxpayers who pay more state and local sales taxes than state and local income taxes (typically lower income taxpayers) would probably choose the option to deduct sales taxes if they do not take the standard deduction. For these states, the data necessary to calculate the number of taxpayers who would choose the sales tax deduction option and the amount of the tax savings are not readily available.

If you should have any questions about this memorandum, please call me on extension 7-7841.

¹ The state itemizer rate is the percentage of all individual income tax returns in a state that claimed itemized deductions divided by total individual income tax returns filed in a state in the 2000 tax year. IRS, *Statistics of Income*, Spring 2002, vol. 21, no. 4, Table 2.

Table 1. Estimated Reduction in Federal Taxes Under a Proposed Sales Tax Paid Federal Income Tax Deduction Option

Average Net Tax Savings Calculated Under the Assumption that the Average Itemizing Taxpayer is in a Hypothetical 30% Marginal Income Tax Bracket for the 2000 Tax Year (\$ in 000s)				
State	State and local sales taxes paid FY2000	State itemizer rate (2000)	Estimated state and local sales taxes paid by itemizers (2000)	Potential taxpayer savings
(a)	(b)	(c)	(d)	(e)
Alaska	\$106,864	24.85%	\$26,556	\$7,967
Florida	\$15,556,791	27.36%	\$4,256,338	\$1,276,872
Nevada	\$2,061,496	34.30%	\$707,093	\$212,147
South Dakota	\$627,225	16.10%	\$100,983	\$30,299
Tennessee	\$7,135,956	22.05%	\$1,573,478	\$471,996
Texas	\$17,348,954	21.24%	\$3,684,918	\$1,105,327
Washington	\$8,918,781	33.76%	\$3,010,980	\$903,616
Wyoming	\$463,975	19.80%	\$91,867	\$27,566

Data in column (b) are from: the U.S. Department of Commerce, Bureau of the Census, *Government Finances: 1999-2000*, published January, 2003, [<http://www.census.gov/govs/www/estimate00.html>]. Data in column (c) are based on data reported in IRS, *Statistics of Income*, Spring 2002, vol. 21, no. 4, Table 2. The estimates in column (d) are column (b) multiplied by column (c). The estimates in column (e) are column (d) multiplied by 30%, the assumed marginal tax rate.